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USPS-T-33

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Postal Rate and Fee Changes, 2000	DOCKET NO. R2000-1

DIRECT TESTIMONY
OF
DAVID R. FRONK
ON BEHALF OF
UNITED STATES POSTAL SERVICE

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AUTOBIOGRAPHICAL SKETCH

My name is David Fronk. I am an Economist in Pricing. My primary duties are to develop Postal Service domestic rate and fee proposals. Specific areas of responsibility include First-Class Mail.

I joined the Postal Service in 1996. Prior to joining the Postal Service, I worked for 15 years as an economic and management consultant. For 10 of those years, I was employed as an Associate, Senior Consultant, and Principal by the consulting firm of Putnam, Hayes & Bartlett, Inc. (and a San Francisco firm which merged into it). For approximately five years, I maintained my own independent consulting practice. My consulting work included ratemaking and forecasting analysis in the electric utility and telecommunications industries. I also worked on a large number of commercial disputes (antitrust, licensing, etc.), primarily in high technology industries. This work frequently involved preparing pricing and demand analyses under alternative assumptions about costs, business conditions, future growth, and competitive response.

Earlier in my career, I also worked as an Economist at the Federal Trade Commission and the Internal Revenue Service, and as a Financial Management Analyst at NASA.

I received a BA in economics and history from the University of Minnesota. I also hold an MA in economics from the George Washington University and an MBA from Stanford University.

This is the third piece of testimony I have filed with the Postal Rate Commission. I also filed direct testimony with the Commission on First-Class Mail rate design in Docket No. R97-1, and on the nonletter-size Business Reply Mail experiment in Docket No. MC97-1.

I. PURPOSE OF TESTIMONY

The purpose of this testimony is to describe the Postal Service's proposed rate design for First-Class Mail and to present the specific First-Class Mail rates that the Postal Service is requesting that the Commission recommend for approval. The rate design will be described in terms of percentage changes, cost coverages, and contribution. The testimony also includes a description of First-Class Mail volume trends, mail characteristics, and a recent rate history. The testimony concludes with a summary of the financial results of the proposed rates in Test Year 2001.

II. GUIDE TO TESTIMONY AND SUPPORTING DOCUMENTATION

This testimony is structured as follows. In Section III, the First-Class Mail rate design is introduced and summarized. Sections IV-VI then provide background information on the characteristics of First-Class Mail and historical data on rates, volumes, and revenues. The following USPS Library References are associated with these sections of my testimony: (1) the 1998 Household Diary Study, USPS LR-I-116, (2) Volume and Revenue Histories, USPS LR-I-117, and (3) Rate History, USPS-LR-I-118. Taken together, Sections IV-VI establish a context within which the rate design can be discussed.

Section VII then presents the rate design. After discussing overall rate design issues in Section VII.A, Section VII.B focuses on the Letters and Sealed Parcels subclass and Section VII.C deals with the Cards subclass. The rate design depends on several inputs from my colleagues. First, witness Mayes

(USPS-T-32) provides the overall revenue requirement and subclass cost coverage targets for First-Class Mail. Second, I rely on the cost work of witness Miller (USPS-T-24) for updated information on worksharing cost savings, witness Daniel (USPS-T-28) for a new weight study relevant for the additional ounce rate, and witness Campbell (USPS-T-29) for updated information on Qualified Business Reply Mail (QBRM) costs. For the nonstandard surcharge, I cite updated cost data developed by witness Miller (USPS-T-24).

My testimony concludes in Section VIII with an overall discussion of the financial impact of the proposed First-Class Mail rates. Section VIII relies on my Workpaper (USPS-T-33 Fronk Workpaper, filed electronically as USPS LR-I-169), which details the revenue and volume results of the rate proposal at the billing determinant level. The Workpaper itself contains references to sources and data relied upon.

III. PROPOSAL

The proposed average changes in revenue per piece for First-Class Mail, including fee revenue, are as follows:

Letters Subclass	3.5%
Cards Subclass	5.0%
Total Class	3.6%

These changes result in revenues that are 196.3 percent of volume variable cost for letters and 148.5 percent of volume variable cost for cards. For the class as a whole, the resulting cost coverage is 194.5 percent.

First-Class Mail letters are the vanguard service and the principal source of revenue and costs for the Postal Service. The most visible postal rate is the first-ounce rate for single-piece letters. The Postal Service proposes a one-cent, or 3.0 percent, increase in this rate (from 33 to 34 cents). This matches the one-penny increase from the last rate case, Docket No. R97-1. We propose an increase in the rate for additional ounces from 22 cents to 23 cents. This rate went down one-cent as a result of Docket No. R97-1. Our proposal would return it to the 23-cent level that prevailed from 1991 until 1999.

The Postal Service is also proposing a one-cent increase in the single-piece card rate (from 20 to 21 cents). The single-piece card rate did not increase as a result of the last rate case. Our proposal would result in the first increase since January 1995.

In terms of worksharing discounts, the Postal Service proposes that automation presort letter discounts remain at their present levels. We also propose that the discount for nonautomation presort letters, flats, and parcels be reduced by 0.5 cents. In addition, we propose that the automation presort card discounts from the single-piece rate increase by 0.2 cents.

With one exception, the Postal Service's proposals keep all elements of the existing First-Class Mail rate structure in place. The proposed rate structure change is a split of the combined 3/5-digit rate for automation flats into separate 3-digit and 5-digit rates. This change is discussed in Section VII. We propose no change in the 13-ounce breakpoint with Priority Mail, as discussed in the testimony of witness Robinson (USPS-T-34 at Section III.E).

The Postal Service's proposed rates for First-Class Mail letters are presented below in Table 1.

Table 1 – Rates for First-Class Letters Subclass

	Current Rate (cents)	Proposed Rate (cents)
Single-Piece & Nonautomation Presort:		
Single Piece (all shapes):		
First-Ounce	33	34
Nonstandard Surcharge	11	11
Qualified Business Reply Mail	30	31
Presorted (all shapes):		
First-Ounce	30.5	32.0
Nonstandard Surcharge	5	5
Heavy Piece Deduction	-4.6	-4.6
Additional Ounce	22	23
Automation:		
Letters (First Ounce):		
Basic Automation	27.0	28.0
3-Digit	26.1	27.1
5-Digit	24.3	25.3
Carrier Route	23.8	24.8
Flats (First Ounce)		
Basic Automation	30.0	31.0
3-Digit Flats	27.0*	29.5
5-Digit Flats	N/A	27.5
Nonstandard Surcharge	5	5
Heavy Piece Deduction	-4.6	-4.6
Additional Ounce	22	23

* This is currently a combined rate for 3/5 Digit flats.

The rates proposed for cards are presented in Table 2.

Table 2 -- Rates for First-Class Cards Subclass

	Current Rate (cents)	Proposed Rate (cents)
Single-Piece & Nonautomation Presort:		
Single-Piece	20	21
Qualified Business Reply Mail	18	18
Nonautomation Presort	18	19
Automation:		
Basic Automation	16.6	17.4
3-Digit	15.9	16.7
5-Digit	14.6	15.4
Carrier Route	14.1	14.9

IV. CHARACTERISTICS OF FIRST-CLASS MAIL

First-Class Mail consists of mailable matter weighing 13 ounces or less. It includes business and personal correspondence, cards, sealed parcels, bills, invoices, remittances, financial statements, and advertising. All mailable matter weighing 13 ounces or less may be sent as First-Class Mail. In practice, a large share of many types of mail eligible for First-Class Mail, such as publications and advertising, is mailed at lower Periodical and Standard (A) rates.

For purposes of market analysis, the First-Class Mail flow can be divided into four sectors: (1) household-to-household, (2) household-to-nonhousehold, (3) nonhousehold-to-household, and (4) nonhousehold-to-nonhousehold.

According to the "Household Diary Study: Fiscal Year 1998,"[1] about 15 percent of First-Class Mail originates from households, transmitted either to other households (6 percent of total First-Class Mail) or to nonhouseholds (9 percent). About 41 percent of First-Class Mail goes from nonhouseholds to households, and the remainder, 44 percent, is nonhousehold-to-nonhousehold mail (USPS-LR-I-116 at Table 4-1).

As might be expected, household-generated First-Class Mail consists primarily of bill payments, greeting cards, and personal correspondence. About 85 percent of the mail sent by households to nonhouseholds in FY 1998 contained some type of payment, for example, utility remittance, credit card payment, or insurance premium (Id. at page IV-112).

The nonhousehold to household sector is a major component of the First-Class Mail stream. The largest volume of First-Class Mail, in terms of content, continues to be bills. On average, households receive 2.9 bills per week (Id. at page IV-43). Approximately 40 percent of bills come from the service sector, including utility and medical bills. The insurance and credit card industries account for about 40 percent of bills as well (Id. at Table 4-19). After bills, the largest volume of First-Class Mail received by households from nonhouseholds consists of advertisements, primarily from credit card companies, publishers, leisure services, specialty stores, banks, and mail order companies (Id. at page IV-40).

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[1] USPS LR-I-116. The other page numbers and table citations in this section were also taken from this source.

The major industry users of First-Class Mail are concentrated in the financial sector. The three largest senders of First-Class industry mail are banks, insurance companies, and credit card companies, which combine for 15 percent of total First-Class Mail volume (Id. at page I-9). This high volume by industry corresponds with the large percentage of the mail stream associated with bills and remittances described earlier. Social/charitable/political/nonprofit organizations account for three percent of total First-Class Mail volume and non-telephone utilities account for approximately two percent (Id. at Table 4-18).

Since 1987, there has been an increase in the percentage of nonhousehold to household mail sent presorted or prebarcoded, up from 54 percent to 68 percent (Id. at page IV-57). The credit card industry presorts most all of its volume (92 percent). Other industries making heavy use of presort include non-telephone utilities (81 percent) and publishers (80 percent) (Id. at page IV-64).

The volume of First-Class Mail received by a household varies according to demographic characteristics. As income and education increase, so does the volume of mail received. According to the 1998 Household Diary Study, households with incomes less than $7,000 per year receive 39 percent of the mail received by households with incomes greater than $100,000 per year (Id. at Table 4-4). Households receiving the largest volume of mail are those headed by an individual aged 45-54 years. Volume then falls off as the age of the head of the household increases. Volume of First-Class Mail received also depends on the occupation of the head of household and whether the household is urban

or rural. As an occupational group, white collar professionals receive the most mail, and suburbanites receive more mail than both city-dwellers and rural households (Id. at Table 4-3).

V. VOLUME AND REVENUE HISTORY

Tables 3-5 below provide historical information on First-Class Mail volumes, revenues, and percentage shares. As indicated in Table 3, First-Class Mail accounts for about 60 percent of domestic mail revenue. Of the $33.9 billion in First-Class Mail revenue in FY 1998, approximately $21.8 billion came from nonpresorted letters, flats and parcels, emphasizing the continuing importance of single-piece mail in the First-Class Mail stream. Cards generated $1.0 billion, or 3.0 percent, of First-Class Mail revenue.

Table 3 also shows that First-Class Mail volume has generally decreased as a percentage of total mail volume over time, dropping from 59 percent of total volume in 1970 to 51 percent in 1998. Most of this decline occurred from 1975 to 1985. First-Class Mail volume as a percentage of total mail volume has remained fairly steady between 1985 and 1998 (ranging from as high as 54% to as low as 51%).

Table 3
First-Class Mail
Summary Volume and Revenue Data
(in millions)

Fiscal Year	First-Class Mail Volume	% of Total Domestic Volume	First-Class Mail Revenue	% of Total Domestic Mail Revenue (Except Spcl. Srvcs.)
1970	50,173	**59%**	$3,492	**63%**
1975	52,482	**59%**	$6,021	**69%**
1980	60,276	**57%**	$10,146	**68%**
1985	72,440	**52%**	$16,740	**65%**
1990	89,270	**54%**	$24,023	**65%**
1995	96,296	**53%**	$31,955	**63%**
1996	98,216	**54%**	$33,117	**63%**
1997	99,660	**52%**	$33,398	**61%**
1998	100,434	**51%**	$33,861*	**60%**

* Single-piece letters, flats, and parcels accounted for $21.8 billion; cards accounted for $1.0 billion.
Source: Volume and Revenue Histories, USPS LR-I-117.

This decline in volume share occurred despite the fact that First-Class Mail volume has increased every year since 1976. As shown below in Table 4, First-Class Mail volume nearly doubled from 1976 to 1998, increasing from 52.5 billion pieces annually to 100.4 billion pieces. The average annual growth rate in First-Class Mail volume has been declining in recent years, however. During the 1980s, First-Class Mail volume increased about 4.0 percent per year on average. During the 1990s, the average annual growth rate has been only 1.8 percent.

While both total letter and card volume have grown similarly over the long run, their patterns of growth do show recent differences. Volume in the letters

Table 4
First-Class Mail Volume Trends
1970-1998
(In millions)

Fiscal Year	Non-presort Letters, Flats, & IPPs	Presort/ Auto-mation Letters, Flats & IPPs	**Total Letters Sub-Class**	Single-Piece Postal Cards	Single-Piece Post Cards	Presort/ Auto-Mation Cards	**Total Cards Sub-Class**	**Total First-Class**
1970	47,769	0	**47,769**	803	1,601	0	**2,404**	**50,173**
1971	49,037	0	**49,037**	717	1,738	0	**2,455**	**51,492**
1972	48,046	0	**48,046**	574	1,673	0	**2,247**	**50,293**
1973	50,008	0	**50,008**	609	1,675	0	**2,284**	**52,292**
1974	50,605	0	**50,605**	568	1,755	0	**2,323**	**52,928**
1975	50,349	0	**50,349**	490	1,643	0	**2,133**	**52,482**
1976	50,310	0	**50,310**	496	1,652	0	**2,148**	**52,458**
1977	49,486	1,832	**51,318**	392	1,595	362	**2,349**	**53,667**
1978	50,826	2,779	**55,605**	343	1,526	508	**2,377**	**55,982**
1979	50,759	4,846	**55,606**	333	1,590	397	**2,320**	**57,926**
1980	51,056	6,838	**57,894**	334	1,489	559	**2,382**	**60,276**
1981	50,133	8,821	**58,955**	297	1,564	595	**2,456**	**61,410**
1982	48,586	11,096	**59,682**	349	1,601	569	**2,519**	**62,200**
1983	48,055	13,355	**61,410**	484	1,656	697	**2,837**	**64,247**
1984	50,267	15,310	**65,578**	340	1,800	711	**2,851**	**68,429**
1985	51,931	17,546	**69,477**	348	2,008	607	**2,963**	**72,440**
1986	53,189	19,808	**72,997**	354	2,024	812	**3,190**	**76,187**
1987	54,160	21,379	**75,539**	373	2,119	838	**3,330**	**78,869**
1988	55,785	24,793	**80,578**	506	2,579	1,086	**4,172**	**84,749**
1989	55,858	25,792	**81,650**	539	2,435	1,231	**4,206**	**85,855**
1990	56,788	27,585	**84,373**	483	2,824	1,590	**4,897**	**89,270**
1991	56,351	28,805	**85,156**	497	2,561	2,070	**5,128**	**90,285**
1992	54,963	31,232	**86,195**	610	2,507	1,470	**4,586**	**90,781**
1993	55,204	32,650	**87,854**	535	2,378	1,401	**4,315**	**92,169**
1994	55,057	35,507	**90,564**	438	2,562	1,768	**4,768**	**95,333**
1995	54,931	36,413	**91,344**	441	2,577	1,935	**4,951**	**96,296**
1996	54,151	39,058	**93,208**	454	2,598	1,956	**5,008**	**98,216**
1997	54,240	40,063	**94,303**	605	2,399	2,353	**5,357**	**99,660**
1998	54,273	40,634	**94,907**	406	2,566	2,555	**5,527**	**100,434**

Source: Volume and Revenue Histories, USPS-LR-I-117.

subclass has grown every year since 1976. Volume in the card subclass has also grown virtually every year, but declined in 1992 and 1993 following the large rate increase implemented in February 1991.

The growth in First-Class Mail since 1976 has been concentrated almost entirely in presorted (both automation and nonautomation) mail. Nonpresort letter, flat, and parcel volume has grown slowly and has fluctuated in the 54 billion to 57 billion piece range during the last 12 years.

On the other hand, presort letter, flat and parcel volume has grown since its inception in 1976 to 40.6 billion pieces in 1998. As Table 5 indicates below, however, there have been significant shifts within the presort category over the last five years. In response to rate incentives and mail preparation requirements, the nonautomation portion of the presort total has shrunk considerably. Simultaneously, the prebarcoded portion of the total, particularly the 3-digit automation rate category, has exploded in volume. In 1998, 3-digit letters accounted for about half of the presort volume in the letters subclass. Card growth has similarly been dominated by the presort category, though cards represent only about 5 percent of First-Class Mail volume.

Table 5
First-Class Mail
Presort/Automation Volume Trends for Letters Subclass
1994-1998
(in millions)

Fiscal Year	Non-Auto. Presort Letters, Flats, & IPPs*	Basic Auto-Mation Letters	3-Digit Auto-Mation Letters	5-Digit Auto-Mation Letters	Basic Auto-Mation Flats	3/5-Digit Auto-Mation Flats	Carrier Route Auto-Mation Letters	**Total Presort/ Auto-mation**
1994	18,569	0	6,797	6,473	0	12	3,146	**35,507**
1995	12,670	0	12,094	8,583	0	37	3,029	**36,413**
1996	10,790	849	15,241	9,251	0	82	2,844	**39,058**
1997	5,642	4,344	19,420	9,082	48	200	1,326	**40,063**
1998	4,658	4,594	19,631	10,203	44	224	1,279	**40,634**

* Includes ZIP + 4 prior to its elimination on July 1, 1996.
Note: Basic Automation rate for letters and flats introduced on July 1, 1996.
Source: First-Class Mail Billing Determinants for 1994-1998.

VI. RATE HISTORY

The most recent changes in First-Class Mail rates occurred on January 10, 1999 as result of Docket No. R97-1. A brief history of First-Class Mail rates follows, with more detail available in USPS Library Reference I-118.

A. Letters and Sealed Parcels Subclass

1. Single-Piece and Additional-Ounce Rate

The basic, first-ounce First-Class Mail letter rate has been changed 10 times since postal reorganization, increasing from 8 cents to 33 cents. The past two increases, occurring in 1995 and 1999, saw the rate go from 29 cents to 32 cents and then to 33 cents.

An additional-ounce rate is charged for ounces above the first ounce. Until 1975, this additional-ounce rate was the same as the first-ounce rate. At that time, a structure was established and subsequently maintained where the additional-ounce rate is less than the first-ounce rate. Over the last 25 years, the additional-ounce rate grew from 9 cents to 23 cents, and then was reduced to 22 cents as a result of Docket No. R97-1. In each set of rate adjustments, except for the nine months when the Commission's Docket No. R80-1 recommended rates were implemented under protest, the additional-ounce rate has changed by the same or a lesser amount than the first-ounce rate, thus gradually increasing the gap between these two rates ("progressive degression"). Since February 1991, the differential between the first-ounce rate and the additional-ounce rate has increased from 6 cents to 11 cents.

2. Presorted and Automation Rates for Letters and Flats

Rates for 3/5-digit presorted, nonautomation First-Class Mail letters were introduced in 1976, with an initial discount of 1 cent off the basic letter rate. Subsequently, that discount was increased to 2 cents in 1978, 3 cents in 1981, 4 cents in 1985, 4.2 cents in 1991, and 4.6 cents in 1995. As a result of Docket No. MC95-1, the size of this discount was reduced to 2.5 cents, consistent with the evolving impact of automated mail processing and the evolution of automation discounts. The discount remained at 2.5 cents as a result of Docket No. R97-1.

Carrier route presort incentives began with a 1-cent discount off the 3/5 digit presort rate in 1981. This incremental discount was increased to 1.5 cents

in 1988, 1.8 cents in 1991, and 2 cents in 1995. As a result of Docket No. MC95-1, the carrier route rate was only made available for delivery-point barcoded letters destinating in zones specified by the Postal Service. At present, the carrier route rate is 0.5 cents less than the 5-digit letter automation rate.

Discounts for ZIP + 4 coded letters were introduced in 1983 at 0.9 cents for nonpresorted letters and 0.5 cents for presorted letters. In 1991, these discounts were increased to 1.4 cents and 0.6 cents, respectively. In 1995, these discounts were increased again to 1.5 cents and 0.7 cents, respectively. As a result of Docket No. MC95-1 classification reform and an organizational strategy emphasizing barcodes, ZIP + 4 discounts were eliminated.

A prebarcoded letter discount was first offered in 1988. The basic automation rate, currently 27.0 cents, was introduced in 1996 for bulk automation pieces that do not meet the 150-piece minimum volume requirement for the 3-digit or 5-digit rates. The current incremental prebarcoded discounts are 0.9 cents for 3-digit presorted pieces (compared to the basic automation rate) and 1.8 cents for 5-digit presorted pieces (compared to the 3-digit rate).

Prebarcoded flat rates were implemented in 1992, at 2.3 cents less than the basic nonpresorted rate and 1.5 cents less than the basic presorted rate. In 1996, the separate discount for nonpresort, prebarcoded flats was eliminated. Instead, prebarcoded flats meeting minimum volume requirements by 3/5-digit area receive a 3.5 cent discount from the nonautomation presort rate, and residual automation pieces pay a basic automation rate for flats.

3. Other Letter Rates

A First-Class Mail piece weighing one ounce or less and exceeding standard letter-size dimensions, or not conforming to a specified range of aspect (length to width) ratios, is assessed a nonstandard surcharge. The nonstandard surcharge for nonpresorted mail was set at 7 cents in 1979, and has increased three times since, to 11 cents today. The nonstandard surcharge for presorted mail was also set at 7 cents in 1979, but has since been reduced to 5 cents.

There is also a heavy piece deduction for presorted mail weighing more than 2 ounces. The discount, introduced at 4.0 cents per piece in 1988, is currently 4.6 cents.

B. Cards Subclass

The basic card rate has gone from 6 cents to 20 cents since postal reorganization. A 1-cent presort discount was introduced in 1976. The discount was increased to 2 cents in 1985, increased again to 2.1 cents in 1995, and then returned to the 2-cent level in 1996, where it remains today. As with letters, an incremental 1-cent carrier route discount from the 3/5 digit presort rate was introduced in 1981. It increased to 1.5 cents in 1988, 1.8 cents in 1991, and 1.9 cents in 1995. As a result of Docket No. MC95-1, the carrier route rate was only made available for delivery-point barcoded cards destinating in zones specified by the Postal Service. The difference between this rate and the 5-digit rate for automation cards is now 0.5 cents.

As with letters, ZIP + 4 discounts were first offered in 1983 at 0.9 cents per piece for nonpresorted cards, and 0.5 cents for presorted cards. By 1995,

these discounts had increased to 1.1 cents and 0.6 cents, respectively. Docket No. MC95-1 classification reform eliminated the ZIP + 4 discount.

A prebarcode discount for cards was offered beginning in 1988. In 1996, the nonpresort prebarcoded rate was eliminated. Instead, cards not meeting the minimum 150-piece volume requirement by 3/5-digit area now pay the basic automation rate of 16.6 cents. The current incremental prebarcoded discounts are 0.7 cents for 3-digit presorted pieces (compared to the basic automation rate) and 1.3 cents for 5-digit presorted pieces (compared to the 3-digit rate).

VII. RATE DESIGN

A. Rate Design Issues

The testimony of witness Mayes (USPS-T-32) discusses how the First-Class Mail rate proposal is consistent with statutory postal ratemaking criteria. In designing First-Class Mail rates, I also considered the following broad rate design issues.

1. Benchmarks and Avoided Costs

One of the key issues affecting First-Class Mail rate design is establishing an appropriate point of comparison for determining automation-related cost savings. That point of comparison is frequently termed the "benchmark" because it is the mail type used as the standard for computing cost savings. Simply stated, cost avoidances and the resulting discounts are measured by subtracting the cost of the rate category under consideration from the benchmark

cost. Consequently, the benchmark is as critical as the measured cost of the rate category in determining the discount.

A key aspect of choosing the benchmark for determining the bulk presort/automation discounts is the broad spectrum of nonpresorted mail. Nonpresorted mail includes everything from "clean" mail (uniform pieces featuring typewritten or pre-printed addresses and often mailed in bulk) to "dirty" mail (pieces featuring handwritten and more frequently incorrect or incomplete addresses) -- and all the mail in between. Using all nonpresort letters as a benchmark results in a larger discount than using a benchmark which tends to have all the attributes of presort/automation mail, except for the actual presortation or application of the barcode.

In its Docket No. MC95-1 Opinion and Recommended Decision, the Commission included an extensive discussion of the benchmark issue. In its analysis, the Commission generally concluded that discounts should be based on the costs that the worksharing activity (presortation, prebarcoded) avoids, rather than full cost differences. Discounts for bulk automation categories based in part on "dirty" mail (rather than the "clean" mail most likely to be candidates for automation) overstate the benefits of worksharing and can create the wrong incentive for mailers. Setting discounts to compensate mailers only for the costs avoided by the Postal Service provides the bulk mailer an incentive to presort or apply a barcode only if it can do so at lower cost than the Postal Service.

In developing the bulk presort/automation discounts for letters and cards in Docket No. R97-1, the Postal Service focused on the costs avoided by

successive degrees of presorting or automation compatibility, consistent with the Commission's Docket No. MC95-1 Decision. The specific benchmark the Postal Service used in setting the discounts for bulk automation letters in Docket No. R97-1 was the sum of mail processing and delivery costs for bulk metered mail.[2] As the Commission had stated in Docket No. MC95-1 (paragraph 4302 at page IV-136), " ...the single-piece mail most likely to convert to the automation categories is limited to the bulk metered mail component." The Postal Service focused on the mail processing and delivery cost aspects of this benchmark in its Docket No. R97-1 proposal because these are the costs that will be affected by presorting and prebarcoding. Transportation and "other costs" are not likely to be avoided as a result of these worksharing activities. The Commission had reached the same conclusion about transportation and "other" costs in Docket No. MC95-1 (paragraph 4273 at page IV-123).

In its Opinion and Recommended Decision in Docket No. R97-1, the Commission reinforced its Docket No. MC95-1 views in its acceptance of the Postal Service's conceptual approach to discounts.

> In general, the Commission agrees with the Service's basic approach to developing worksharing cost savings. In particular, the Commission commends the Service's proposed adoption of bulk metered mail (BMM) as the basis for calculating unit mail processing cost differences. It also agrees with the Service that the measured costs should be limited to activities exhibiting identifiable savings, namely unit processing and delivery costs." [paragraph 5027 at page 268]

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[2] Bulk metered mail refers to meter belt bypass mail. This is metered letter mail which is trayed by the mailer, so it does not require the preparation that bundled metered letters would. Similarly, bulk metered mail does not require facing and canceling.

Consistent with precedent, the discounts the Postal Service is proposing here use the same approach as in Docket No. R97-1, that is, the bulk metered benchmark is used in conjunction with mail processing and delivery costs to measure costs avoided. The statutory pricing criteria call for a balanced consideration of a number of factors, including fairness and equity, the effect of the rate increase on mailers, and simplicity in the rate structure. Accordingly, in designing rates, I have not limited myself exclusively to consideration of cost avoidance estimates.

2. Postal Service Automation Goals and Discount Trends

For a number of years, the Postal Service has been relying on automation to control the costs of mail processing and delivery functions. The goal has been to continue working toward a mailstream that is as barcoded as practicable. I have taken account of the importance of the automation program by proposing discounts that recognize the need for continued bulk mailer participation in that automation program.

The following table highlights the recent trend in discounts for both 3-digit and 5-digit letters. These two rate categories together comprise the great majority of workshared First-Class Mail – 69 percent in 1998.

Table 6
First-Class Mail 3-Digit and 5-Digit Letters
Discount Summary
(in cents)

	Discount from Single-Piece Letter Rate		
Rate Category	Docket No. R94-1	Docket No. MC95-1	Docket No. R97-1
3-Digit Letter	5.6	6.6	6.9
5-Digit Letter	6.2	8.2	8.7

As indicated in Table 6, discounts for the largest two rate categories of workshared First-Class Mail increased between Docket Nos. R94-1 and R97-1. Comparing rates between Docket No. R94-1 and Docket No. R97-1, the single-piece letter rate went from 29 cents to 33 cents, an increase of 13.8 percent. Over the same four-year period, the 3-digit letter rate went from 26.4 cents to 26.1 cents, a decrease of 1.1 percent. The 5-digit letter rate went from 25.8 cents to 24.3 cents, a decrease of 5.8 percent. It should be noted that there were also changes between Docket No. R94-1 and Docket No. MC95-1 in the minimum number of pieces needed to qualify for these rates. The minimum number of pieces for the 3-digit rate went from 50 to 150 and the minimum number of pieces for the 5-digit rate went from 10 to 150.

The cost analysis performed for the current docket by witness Miller (USPS-T-24) demonstrates that the cost differences between automation tiers are now smaller than they were estimated to be in Docket No. R97-1. As a result, if the proposed workshare discounts were tied strictly to avoided costs, many discounts would need to be reduced. Instead, the Postal Service's proposal in this docket will generally maintain workshare discounts at their present levels, as discussed in detail below. However, if the cost data presented in this docket are the beginning of a new cost trend indicating that the value of worksharing to the Postal Service has peaked, then the mailing community might anticipate smaller discount proposals in the future.

B. Rate Proposal for the Letters and Sealed Parcels Subclass

1. Single-Piece and Nonautomation Presort Letters, Flats, and Parcels

The rate structure for single-piece and nonautomation presort letters, flats and parcels currently consists of six components: (1) the single-piece, first-ounce rate, (2) the Qualified Business Reply Mail (QBRM) rate, (3) the additional-ounce rate, (4) the nonautomation presort rate, (5) the nonstandard surcharge, and (6) the heavy piece discount. The Postal Service proposes retaining all elements of this rate structure.

a. Single-Piece Letters, Flats, and Parcels

The basic one-ounce rate is the most visible and important rate in the eyes of the general public. In 1998, the basic rate (first-ounce only) accounted for about 30 percent of domestic mail revenue, far more than any other rate category in any other class of mail.

The Postal Service is proposing an increase of one cent, or 3.0 percent, in the basic rate. This one-cent increase matches that in Docket No. R97-1, which was the smallest proposed increase since postal reorganization.

This increase is consistent with the Postal Service's revenue requirement and the statutory ratemaking criteria of the Act. In view of that revenue requirement, a proposal not to change this rate would impose unreasonably large rate increases in other classes of mail. Conversely, a two-cent increase in the basic rate would unfairly relieve other mail classes of their fair share of the institutional cost burden.

For administrative ease and to avoid unnecessary complexity for the general mailing public, the Postal Service is continuing the practice of proposing this rate in whole cents.

b. Qualified Business Reply Mail

As a result of Docket No. R97-1, the Postal Service implemented a new discounted letter rate of 30 cents for Qualified Business Reply Mail (QBRM). To qualify for the discounted rate, mailers need to be pre-approved and prepare prebarcoded, automation-compatible Business Reply Mail. In effect, QBRM replaced the previous Business Reply Mail Accounting System pricing structure, which involved full single-piece postage and per-piece fees, with a new structure that features discounted postage and per-piece fees. For this docket, the Postal Service proposes a one-cent increase in the QBRM postage rate, from 30 to 31 cents.[3]

The proposed increase in the QBRM postage rate will maintain the discount at three cents below the single-piece rate. The new cost study prepared by witness Campbell (USPS-T-29 at Section IV.D) shows a cost avoidance of 3.4 cents, applicable to both letters and cards. My proposal passes through 90 percent of this measured cost avoidance. The three-cent postage discount, coupled with the new fee structure proposed by witness Mayo (USPS-T-39), can result in substantial savings for those customers receiving more than approximately 113,000 pieces of BRM annually.

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[3] See the testimony of witness Mayo, USPS-T-39 at Section IV.D, for a discussion of BRM fees.

QBRM is clean, prebarcoded mail and incurs less cost than non-barcoded mail. Automation-compatible First-Class Business Reply Mail is used daily by millions of individuals and small businesses. By recognizing cost savings associated with this mail, the Postal Service is able to permit a broader base of customers to more directly share in the benefits of automation.

c. Additional-Ounce Rate

The Postal Service proposes an additional ounce rate of 23 cents for both single-piece and presorted mail. This represents a one-cent increase over the present rate, and returns the rate to the level that prevailed from 1991 until 1999.

This proposal maintains the current difference of 11 cents between the first-ounce rate and the additional-ounce rate. The "degression" in the additional-ounce rate increased from 6 cents as a result of Docket No. R90-1 (29 cents minus 23 cents), to 9 cents as a result of Docket No. R94-1 (32 cents minus 23 cents), and to 11 cents as a result of Docket No. R97-1 (33 cents minus 22 cents).

The additional-ounce rate continues to be an important source of revenue for the Postal Service. In FY 1998, additional ounces generated about $4.7 billion in revenue, or 14 percent of First-Class Mail revenue for the year. The Docket No. R97-1 change in the breakpoint with Priority Mail from 11 to 13 ounces will work to increase the number of First-Class Mail additional ounces and the revenue importance of this rate. Accordingly, the additional ounce rate is an important factor in helping First-Class Mail meet its cost coverage target and in helping the Postal Service meet its revenue requirement.

Several considerations went into developing the proposed 23-cent rate, including achievement of the revenue requirement and the First-Class Mail cost coverage provided by witness Mayes. The Postal Service also considers it important to develop an additional ounce rate that reflects the underlying costs the rate is designed to recover. The testimony of witness Daniel (USPS-T-28) presents the results of the First-Class Mail weight study prepared for this docket.

As noted by witness Daniel (USPS-T-28), there is difficulty in measuring additional ounce costs with the highest degree of precision on a weight-step-by-weight-step basis. Nevertheless, the weight study does provide a basis for evaluating, in the aggregate, the alignment between the additional ounce rate and the overall costs it is designed to recover. Also, the weight study provides a basis for addressing potential concerns that there may be a large disparity between the additional ounce rate and its underlying costs.

As discussed in USPS-T-28, the weight study develops costs for both single-piece and presort. On average, across all weight steps, each additional ounce for single-piece mail adds 12.5 cents to cost (USPS-T-28, Table 1), while each additional ounce for a presort mail piece adds 14.8 cents to cost (Id. at Table 2). Taking single-piece and presort mail together, each additional ounce on average adds 12.7 cents to First-Class Mail costs.[4]

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[4] Calculated by using the data in USPS-T-28 as follows: 12.5 cents for single–piece calculated in Table 1 by taking $2,236,175,478 in costs / 17,967,736,454 additional ounces, and 14.8 cents presort calculated in Table 2 by taking $389,874,405 in costs / 2,639,970,578 additional ounces. The weighted average of the two is 12.743, or $2,626,049,883 in costs ($2,236,175,478 + $389,874,405) divided by 20,607,707,032 additional ounces (17,967,736,454 + 2,639,970,578).

While the concept of mark-up applies most directly at the subclass level, examining the mark-up for an individual rate can give an indication of how the rate compares with the rate/cost relationship for the subclass as a whole. As shown in the First-Class Mail Test Year Summary (below in Attachment USPS-33B), the mark-up for the letters subclass at proposed rates is approximately 96 percent. The mark-up for the additional ounce rate is approximately 81 percent (23 cents in revenue per ounce/12.7 cents in cost per ounce), which is somewhat below, but generally consistent with the subclass as a whole. Because the additional ounce mark-up is below the subclass average, the additional ounce rate is serving to reduce the overall mark-up for the letters subclass.

The cost data compiled by witness Daniel also show that the first additional ounce of single-piece mail adds 22.4 cents to unit costs (USPS-T-28 at Table 1), while the first additional ounce of presort mail adds 17.7 cents to cost (Id. at Table 2). In general, subsequent additional ounces add less to costs than the first additional ounce for both single-piece and presort mail.

In addition, while the first additional-ounce costs less for presort mail than for single-piece mail, these costs catch up for heavier pieces. This cost behavior argues against a lower additional-ounce rate for presort, since the lower rate would steadily increase the presort discount as the weight of the piece increased, even though the weight study data indicate that the cost difference does not continue to increase for heavier pieces.

It might be argued that the rates for additional ounces of First-Class Mail should be strictly cost based. Under such a scheme, the rates for additional

ounces would vary from ounce increment to ounce increment to reflect a more-or-less constant cost coverage. The Postal Service views this as undesirable for at least three reasons. The first is the difficulty in measuring additional ounce costs with great precision, especially for heavier presort pieces with relatively low volume. It is one thing to examine additional ounce costs in the aggregate across all weight increments; it is quite another thing to attempt to fine-tune rates from ounce increment-to-ounce increment based on disaggregated cost data.

The second reason why the Postal Service views varying rates as undesirable is simplicity in rate design for single-piece mailers. A uniform rate design with a single stamp that can be used for each additional ounce of postage is simple and easy for the general public to use.

The third reason is that, given a uniform rate for single-piece mailers, a non-uniform rate for bulk mailers could create a skewed set of incentives to presort. The presort discount from single-piece could vary significantly from weight step to weight step, creating an unpredictable workshare response.

d. Presorted, Nonautomation Rate for Letters, Flats, and Parcels

The Postal Service proposes a nonautomation presort rate of 32.0 cents, or 2.0 cents below the proposed single-piece rate. This proposal reduces the current discount of 2.5 cents by 0.5 cents and reflects the newly measured cost avoidance of only 0.1 cents, compared to the bulk metered benchmark cost (see USPS-T-24 at Table 1). As discussed in the testimony of witness Miller, the

measured cost avoidance now reflects the Postal Service's ability to better isolate nonautomation presort costs.

I passed through more than the measured cost avoidance because the proposed rate of 32.0 cents represents a 20 percent reduction in the discount and an increase in the price of close to 5.0 percent. An even greater reduction in the discount at this time (and a correspondingly greater increase in the price) could have resulted in a significant rate impact for our customers mailing at the nonautomation presort rate. A more moderate reduction in the discount reflects the appropriate balance between recognizing the implications of the new cost data and acknowledging the impact that a sharp rate increase would have on our customers. As indicated earlier, if the costs presented in this docket are the beginning of a new cost trend indicating that the value of worksharing to the Postal Service has peaked, then the mailing community might anticipate smaller discounts in the future.

e. Nonstandard Surcharge

The Postal Service proposes maintaining the nonstandard surcharge at 11 cents for nonpresort mail weighing one ounce or less. The nonstandard surcharge for nonpresort mail was last changed in 1995 when it was increased by one penny. In addition, the Postal Service proposes maintaining the 5-cent nonstandard surcharge for presort mail weighing one ounce or less, the rate level that has prevailed since 1988.

In Docket No. R97-1, the Postal Service proposed increases in the nonstandard surcharge for both nonpresort and presort mail. Those proposals

and the supporting cost study drew criticism and considerable attention from intervening parties. The Docket No. R2000-1 testimony of witness Miller (USPS-T-24 at Attachment USPS-24B) addresses several mail processing and cost issues which surfaced in the earlier docket, demonstrating that the Postal Service has made substantial progress in addressing that criticism.

The nonstandard surcharge performs an important role in signaling mailers that the cost of processing nonstandard pieces is higher. Mailers may find that a nonstandard piece will best meet their needs and that they are willing to pay the corresponding surcharge. However, if the price mailers pay for nonstandard pieces is not sufficiently high, the Postal Service may not properly signal the impact of nonstandard pieces on its mail processing operations. Generally, it is the Postal Service's policy to provide mailers with a low-cost method of processing differently shaped and sized one-ounce First-Class Mail pieces. Some standardization of basic mail pieces is necessary to achieve this objective, and the nonstandard surcharge encourages such standardization. Without an appropriate surcharge, Postal Service mail processing operations could be adversely affected by large numbers of nonstandard pieces.

In his study, witness Miller obtains nonstandard surcharge costs of 23.4 cents for nonpresort nonstandard pieces and 9.3 cents for presort nonstandard pieces. These costs are clearly above the present levels of the surcharge for both nonpresort and presort mail.

While witness Miller's study makes significant progress in addressing issues identified in Docket No. R97-1, even his improved nonstandard cost

estimates do not achieve the ideal of completely excluding the costs of pieces which weigh over one ounce. Accordingly, the Postal Service's nonstandard surcharge proposals are influenced by, but not tied strictly to costs. The proposals also reflect consideration of underlying policy objectives.

By proposing retention of the current nonstandard surcharges, the Postal Service's primary objective is clearly not to achieve absolute precision in de-averaging the rates for disparate one-ounce First-Class Mail pieces or to maximize revenue generated by nonstandard pieces. If those objectives were paramount, the Postal Service would propose surcharges at or near the level of the costs provided by witness Miller. Instead, the proposed surcharges should be set at a level which ensures that nonstandard one-ounce mail pieces directly pay a reasonable proportion of the costs associated with their nonstandard nature. The Postal Service considers that the primary purpose of the nonstandard surcharges should be to modify mailer behavior by encouraging a high degree of standardization of basic one-ounce pieces, which increases the efficiency of mail processing operations. As a result, the surcharges should be set at a level which provides a significant financial incentive to design mail pieces so that they contribute to operational efficiency.

At the same time, the Postal Service recognizes that there are one-ounce First-Class Mail pieces which, because of the physical features of their contents, cannot be "standardized." It does not seem necessary to impose a surcharge which reflects the full cost of "nonstandard-ness" in order to influence a desirable degree of mailer standardization. Nor does it seem necessary to set

the surcharge at a level that would appear to punish those mailers who cannot alter their mail pieces.

Witness Miller's nonstandard surcharge cost study (USPS-T-24 at Attachment USPS-24B) confirms witness Daniel's Docket No. R97-1 conclusion that the surcharges do not fully reflect the costs attributable to the nonstandard character of one-ounce First-Class Mail pieces. His affirmation of her results should lead to a general concurrence that the Postal Service and the Commission should take a less strictly cost-driven, more policy-oriented approach to the establishment of the surcharges. Such an approach should impose a reasonable proportion of the extra costs of nonstandard pieces directly on those pieces and spread the remainder of the costs on the overwhelmingly larger pool of First-Class Mail pieces (to negligible effect).

The surcharges should also reflect reasonable rate relationships among standard one-ounce pieces, nonstandard one-ounce pieces, and two-ounce pieces of First-Class Mail. Improvements in cost measurement or the need to avoid a degradation of mail processing efficiency should also be considered as a basis for future adjustments. Preservation of the current surcharges should be interpreted as a first step toward adopting such an approach for the long term.

f. Heavy Piece Discount

In Docket No. R87-1, the Commission recommended and the Governors approved the adoption of an additional 4-cent heavy-piece discount for presorted mail pieces weighing more than two ounces. At present, this discount is 4.6 cents; the Postal Service proposes maintaining this discount at its present level.

As noted in the discussion on the additional ounce rate above, the cost data compiled by witness Daniel (USPS-T-28 at Tables 1 and 2) show that, while the initial additional-ounce costs for presort mail are less than those of single-piece mail, these costs catch up for heavier pieces. This cost behavior argued against a lower additional-ounce rate for presort, since the lower rate would increase the presort discount as the weight of the piece increased, even though available data indicate that the cost difference does not continue to increase for heavier pieces. This cost behavior, however, does support the discount for pieces weighing more than two ounces. A one-time discount recognizes that initial additional ounces cost less for presort, but that this difference does not continue to grow as the pieces get heavier.

2. Automation Letters and Flats

The rate structure for automation letters and flats consists of several components.[5] The rate structure for bulk automation letters consists of four tiers: basic, 3-digit, 5-digit, and carrier route. To be eligible for these rates, a mailing must consist of 500 or more prebarcoded pieces. Further, to be eligible for the 3-digit (or 5-digit) rate, the mailing must have at least 150 pieces to the same 3-digit (or 5-digit) ZIP Code/scheme destination. Pieces that do not meet the 150-piece minimum pay the basic automation rate. Thus, the basic automation rate can be viewed as a rate for bulk residual barcoded pieces. The carrier route

[5] The preceding discussions of the additional ounce rate (Section VII.B.1.c) and the heavy piece discount (Section VII.B.1.f) also apply here. In addition, the preceding nonstandard surcharge discussion (Section VII.B.1.e) also applies to automation flats.

letter rate is only available for delivery-point barcoded letters destinating in zones specified by the Postal Service. Further, the mailing must have at least 10 pieces per carrier route. Pieces destined for routes with less than 10 pieces do not qualify for this rate category.

The rate structure for bulk automation flats currently consists of two components: basic and 3/5-digit. To be eligible for these rates, the mailing must consist of 500 or more pieces. Further, to be eligible for the 3/5-digit rate, the mailing must have at least 10 pieces to the same 5-digit ZIP Code or at least 10 pieces to the same 3-digit ZIP code; remaining pieces pay the basic automation rate for flats. The mailer is required to sort to the 5-digit level if the mailer has 10 or more pieces to the same 5-digit ZIP code. As in the case of letters, the basic automation rate can be viewed as a rate for bulk residual barcoded pieces.

The Postal Service is not proposing any changes in the piece minimums associated with this rate structure. In addition, all existing automation tiers will be retained, with the exception that we propose that the current combined 3/5-digit flat rate be disaggregated into a 3-digit rate and a 5-digit rate.

Unit cost savings for the bulk automation letter tiers are shown below in Table 7. The savings shown for basic automation are in relation to the bulk metered benchmark, while the 3-digit, 5-digit and carrier route savings shown are in terms of the previous automation tier (for example, 3-digit in terms of basic automation or 5-digit in terms of 3-digit automation). As noted previously, the single-piece mail most likely to convert to the automation categories is bulk metered mail, making it the appropriate benchmark.

Table 7
Unit Cost Savings and Discounts for Automation Letters

	Unit Cost Savings* (Cents)	Current Discount (Cents)	Proposed Discount (Cents)
Basic Automation	4.9	6.0	6.0
3-Digit	1.0	0.9	0.9
5-Digit	1.2	1.8	1.8
Carrier Route	0.3	0.5	0.5

* Unit costs include mail processing and delivery costs. Source USPS-T-24 at Table 1.

Table 7 also presents the current and proposed discounts for automation letters, where discounts, like unit cost savings, are expressed in terms of the previous tier. As shown in the table, the newly measured cost avoidances are now below the current discounts in key instances. For example, the rate for basic automation letters is currently 6.0 cents below the single-piece rate. The latest cost data show that the mail processing and delivery costs avoided by a basic automation letter are now 4.9 cents, which, by itself, would suggest that the discount should be reduced by 1.1 cents, to 4.9 cents below the single-piece rate.

Instead, the passthroughs and the discounts that underlie the proposed rates were selected to balance several goals, including: (1) achieving the cost coverage target provided by witness Mayes, (2) recognizing the value of mailer worksharing, (3) avoiding changes in discount levels which result in disruptive rate impacts, and (4) acknowledging the importance of mailer barcoding in overall postal operations. Mailers have invested significantly in automation equipment and changed their mail processes as a result of the recent expansion

in worksharing incentives, and it would be unfair to sharply reverse these incentives. At the same time, the Postal Service could experience operational difficulties if a large portion of the nearly 45 billion workshared First-Class Mail pieces reverted to the Postal Service for sorting and barcoding.

a. Basic Automation Letters

The Table 7 difference in unit costs between a basic automation letter and the bulk metered benchmark is 4.9 cents. The current basic automation rate is 6.0 cents below the single-piece rate. Thus, the latest cost data, taken by itself, would suggest that this discount should be reduced by 1.1 cents, to 4.9 cents below the single-piece rate. Since the discounts for the subsequent automation tiers are keyed to the basic automation starting point, any decision to reduce the basic automation discount would also work to reduce the discounts from the single-piece rate for 3-digit, 5-digit, and carrier route mail.

Instead, the Postal Service is proposing to pass through 122% of the measured cost avoidance and maintain this discount at its present level of 6.0 cents. This results in a one–cent increase in this rate from its present 27.0 cents to a proposed 28.0 cents. This is consistent with the ratemaking goals described above, including the avoidance of disruptive rate increases and the maintenance of incentives to automate. The fact that this represents a shift from the trend toward expanding discounts serves to signal the mailing community about the smaller cost avoidances that are currently being measured.

b. 3-Digit Letters

This rate applies to the largest volume of barcoded letters. In the test year, more than one-half of the automation letters are in this rate category. The Postal Service proposes a one-cent increase in the current 26.1 cent rate to 27.1 cents.

This proposed rate maintains the discount at its present 0.9 cents below the basic automation rate and 6.9 cents below the single-piece rate. While this proposal passes through somewhat less than the amount of avoided costs between basic automation and 3-digit letters (90 percent), it also results in a passthrough of 117 percent of the measured cost avoidance between the bulk metered benchmark and 3-digit letters (6.9 cents / 5.9 cents). As such, the discussion regarding the basic automation rate design is also applicable here.

c. 5-Digit Letters

Consistent with its rate proposals for basic automation and 3-digit letters, the Postal Service proposes maintaining the current 1.8 cent discount from the 3-digit rate (compared with the 1.2-cent measured cost avoidance between the 3-digit and 5-digit automation tiers). The proposed rate is 25.3 cents, a 4.1 percent increase over the current rate. Use of this rate category, which contains the second largest volume among automated rate categories, is optional. Mailers can be expected to use this rate only when their cost of making the 5-digit separation is less than the rate difference between the 3-digit and 5-digit rates, and when their mailings have sufficient geographic density. Again, the

rate design reflects the blending of several factors, including costs, customer impact, and operational goals.

d. Carrier Route Letters

The Postal Service proposes maintaining the carrier route rate at 0.5 cents below the proposed 5-digit rate. The resulting rate is 24.8 cents, a 4.2 percent increase over the current rate. This proposed discount compares with the measured cost differential of 0.3 cents between 5-digit and carrier route mail, and again reflects the consideration of several factors, including costs, customer impact, and operational goals.

e. Automation Flats

The rate structure for bulk barcoded flats currently has two tiers: a basic barcoded rate and 3/5-digit presort rate. The Postal Service proposes creating three tiers by disaggregating the 3/5-digit combined rate into a 3-digit rate and a 5-digit rate. Preparation to the 5-digit level would be optional, as is the case with letters today. All other mail preparation requirements would remain the same. This split is designed to recognize the additional mailer preparation involved in sorting to the 5-digit level when mailers choose to do so, and to avoid burdening mailers with mandatory 5-digit separations.

The Postal Service proposes a one-cent increase in the basic automation rate, from 30 to 31 cents. The Postal Service further proposes a new 3-digit flat rate of 29.5 cents and a new 5-digit flat rate of 27.5 cents. At present, the combined 3/5-digit flat rate is 27 cents. The most recent mail characteristics

data available[6] indicate that currently about 90 percent of the combined 3/5-digit volume is prepared to the 5-digit level, with about 10 percent prepared to the 3-digit level. If these percentages were to hold under a disaggregated regime, the average rate that current 3/5-digit flat mailers would pay would be approximately 27.7 cents (0.9 * 27.5 cents + 0.1 * 29.5 cents). This increase of 0.7 cents over the current 27-cent combined rate is in line with the increases for other First-Class Mail rates.

The proposed bulk automation flat rates are designed primarily to preserve the appropriate rate relationships between letters and flats in the automated arena, and between automation flats and the nonautomation presort rate that applies to both letters and flats. These considerations are most easily seen in the proposed rates for two-ounce pieces (to eliminate the effect of the nonstandard surcharge):

	----Automation-----		Nonauto Presort
	Letters	Flats	Letters/Flats
Basic	51.0	54.0	
3-Digit Letters/Flats	50.1	52.5	55.0
5-Digit Letters/Flats	48.3	50.5	

With the proposed rate relationships, barcoded flats pay less postage than nonautomation presort flats, and more postage than barcoded letters at all

[6] See USPS-T-33 Fronk Workpaper at page 4.

automation tiers. This design is consistent with the postal ratemaking criterion which calls for simple, identifiable relationships among rates.

The proposal to create separate 3-digit and 5-digit automation flat rates is also consistent with the statutory criteria governing changes to classification schedules. The proposal promotes fairness and equity by recognizing the additional mailer preparation involved in sorting to the 5-digit level when mailers choose to do so. Mailers are no longer burdened with mandatory 5-digit separations. The proposal also creates a rate structure that more closely parallels that for automation letters. The proposed new classification enhances the desirability of the mail by better meeting the mail preparation needs of our customers and by better reflecting customer worksharing efforts.

C. Rate Proposal for the Cards Subclass

As discussed below, the proposed percentage increases for cards are somewhat higher than those proposed for letters. In large part, this is the result of applying increases similar in magnitude to those for letters to lower current card prices. For administrative ease and to avoid unnecessary complexity for the general mailing public, the Postal Service is continuing the practice of proposing the most broadly used rates in whole cents.

1. NonAutomation Cards

a. Single-Piece Cards

Single-piece cards account for about 60 percent of card revenues, more than any other card rate category. As was the case with single-piece letters, the Postal Service is also proposing an increase of one cent in the basic card rate.

Since the single-piece card rate did not increase as a result of the last rate case, the proposed increase would be the first since January 1995. The proposed rate of 21 cents represents an increase of 5 percent, and retains the 13-cent gap with the single-piece letter rate.

As in the past, this rate is proposed in whole cents for administrative ease and to avoid unnecessary complexity for the general mailing public. Also, a one-penny increase is the amount consistent with the subclass cost coverage target.

b. Qualified Business Reply Cards

As a result of Docket No. R97-1, the Postal Service implemented a new discounted card rate of 18 cents for Qualified Business Reply Mail (QBRM). To qualify for the discounted rate, mailers need to be pre-approved and prepare prebarcoded, automation-compatible Business Reply Mail cards. In effect, QBRM replaced the previous Business Reply Mail Accounting System pricing structure, which involved full single-piece postage and per piece fees, with a new structure that features discounted postage and per piece fees. For this docket, the Postal Service proposes maintaining the QBRM postage rate at 18 cents.[7]

Maintaining the QBRM card rate at 18 cents will expand the QBRM card discount to three cents below the single-piece card rate, matching the three-cent discount for QBRM letters. The new cost study prepared by witness Campbell (USPS-T-29 at Section IV.D) shows a cost avoidance of 3.4 cents, applicable to both letters and cards. My proposal passes through 90 percent of this measured

[7] See the testimony of witness Mayo, USPS-T-39 at Section IV.D, for a discussion of BRM fees.

cost avoidance. The three-cent discount, coupled with the new fee structure proposed by witness Mayo (USPS-T-39), can result in substantial savings for those customers receiving more than approximately 113,000 pieces of BRM annually.

QBRM is clean, prebarcoded mail and incurs less cost than non-barcoded mail. Automation-compatible First-Class reply cards are used daily by millions of individuals and small businesses. By recognizing some cost savings associated with this mail, the Postal Service is able to permit a broader base of customers to more directly share in the benefits of automation.

c. Nonautomation Presort Cards

The Postal Service proposes a one-cent increase in the nonautomation presort card rate. This proposal maintains the two-cent discount from the single-piece card rate. It is also consistent with the proposed 2-cent difference between the single-piece letter rate and the rate for nonautomation presort letters.

2. Automation Presort Cards

The rate structure for automation presort and carrier route cards consists of four tiers: basic, 3-digit, 5-digit, and carrier route. As is the case with letters, a mailing must consist of 500 or more prebarcoded pieces to be eligible for the 3-digit and 5-digit rates. Further, to be eligible for the 3-digit (or 5-digit) rate, the mailing must have at least 150 pieces to the same 3-digit (or 5-digit) ZIP Code/scheme destination. Pieces that do not meet the 150-piece volume

minimum pay the basic automation rate. Thus, the basic automation rate can be viewed as a rate for bulk residual prebarcoded pieces.

The carrier route letter rate is only available for delivery-point barcoded letters destinating in zones specified by the USPS. Further, the mailing must have at least 10 pieces per route. Pieces destined for routes with less than 10 pieces do not qualify for this category.

The Postal Service does not propose any changes in the piece minimums associated with this rate structure. In addition, the Postal Service proposal retains all existing automation tiers.

The cost analysis performed for this docket indicates the cost savings for the 3-digit and 5-digit automation tiers are now smaller than the current discounts for these tiers (USPS-T-24 at Table 1). Consequently, if the proposed workshare discounts for 3-digit and 5-digit automation cards were tied strictly to avoided costs, these two discounts would need to be reduced. Instead, as was the case with letters, the passthroughs and the discounts that underlie the proposed rates were selected to balance several goals, including: (1) achieving the cost coverage target provided by witness Mayes, (2) recognizing the value of mailer worksharing, (3) avoiding changes in discount levels which result in disruptive rate impacts, and (4) acknowledging the importance of mailer barcoding in overall postal operations.

As a result, the Postal Service's rate proposal in this docket will maintain the 3-digit and 5-digit discounts, as well as the carrier route discount, at their present levels for cards. The updated cost savings for the basic automation tier,

however, indicate that an expansion of this discount is warranted. Since the discounts for the subsequent automation tiers are keyed to this basic automation starting point, the proposal to increase the basic automation discount for cards by 0.2 cents also works to increase the discounts from the single-piece rate for 3-digit, 5-digit, and carrier route cards.

As discussed in detail below, this approach to rate design mitigates the size of the percentage increases in the rates for automation cards; the percentage increases approximate the 5.0 percent increase for single-piece cards. Each proposed card automation rate is 0.8 cents above its present level.

a. Basic Automation Cards

This rate is currently 1.4 cents below the nonautomation presort rate. Based on updated cost data, the Postal Service proposes expanding this discount by 0.2 cents to 1.6 cents. This expanded discount represents a 94 percent passthrough of the 1.7-cent measured cost difference between nonautomation presort and basic automation cards. The resulting rate is 17.4 cents, a 4.8 percent increase over the current rate.

b. 3-Digit Cards

The Postal Service proposes maintaining the 0.7 cent discount between the basic automation rate and the 3-digit rate, notwithstanding the 0.5-cent measured cost difference. The resulting rate of 16.7 cents is 5.0 percent above its current level. As was the case with letters, the Postal Service is mitigating the impact on card rates that rigid adherence to a 100 percent passthrough would

imply. Moreover, coupled with the larger basic automation discount for cards, the proposal reflects a larger discount from the single-piece rate.

c. 5-Digit Cards

The proposed 5-digit rate represents the maintenance of the existing discount of 1.3 cents between 3-digit and 5-digit cards, nonwithstanding the 0.7 cent measured cost difference between the two automation tiers. Use of this rate category is optional. Mailers can be expected to use this rate only when their cost of making the 5-digit separation is less than the rate difference.

d. Carrier Route Cards

The Postal Service is proposing to maintain the carrier route rate at 0.5 cents below the proposed 5-digit rate. While the cost data suggest that a larger carrier route discount could be proposed, the cost estimates are based on a small amount of data due to the small volume in this rate category. An incremental discount of 0.5 cents would match the incremental discount for letters, where considerably more data are available. The proposed rate difference does recognize the extra mailer preparation required to make carrier route trays and packages.

VIII. SUMMARY OF THE FINANCIAL IMPACT OF THE RATE DESIGN

The overall rate proposal, including percentage changes in the rates for each rate category, is presented in Attachment USPS-33A to this testimony. The financial impact of the rate design is detailed in Attachment USPS-33B. The calculations supporting these financial results are contained in my Workpaper

(USPS-T-33 Fronk Workpaper). The key financial results are summarized below in Table 8. Revenues include fees.

Table 8
Estimated Total Revenue, Cost, and Contribution
Test Year 2001 After Rates
($ thousands)

	Revenue	Cost	Contribution	Percentage Rate Increase
Letters	$36,231,201	$18,456,821	$17,774,380	3.5%
Cards	$1,052,689	$708,877	$343,812	5.0%
Total Class	$37,283,890	$19,165,698	$18,118,192	3.6%

FIRST-CLASS MAIL PROPOSED RATES

	Current Rate (Cents)	**Proposed Rate (Cents)**	% Change
REGULAR:			
Letters, Flats & IPPs:			
Non-presorted:			
First Ounce (except QBRM)	33	**34**	3.03%
Qualified Business Reply Mail	30	**31**	3.33%
Nonstandard Surcharge	11	**11**	0.00%
Nonautomation Presort:			
First Ounce	30.5	**32.0**	4.92%
Heavy Piece Deduction	-4.6	**-4.6**	0.00%
Nonstandard Surcharge	5	**5**	0.00%
Additional Ounce	22	**23**	4.55%
Cards:			
Single Piece (except QBRM)	20	**21**	5.00%
Qualified Business Reply Mail	18	**18**	0.00%
Nonautomation Presort	18	**19**	5.56%
AUTOMATION:			
Letters & Flats:			
Letters (First Ounce):			
Basic Automation	27.0	**28.0**	3.70%
3-Digit Letters	26.1	**27.1**	3.83%
5-Digit Letters	24.3	**25.3**	4.12%
Carrier Route Letters	23.8	**24.8**	4.20%
Flats (First Ounce):			
Basic Automation	30.0	**31.0**	3.33%
3-Digit Flats*	27.0	**29.5**	N/A
5-Digit Flats	N/A	**27.5**	N/A
Nonstandard Surcharge	5	**5**	0.00%
Additional Ounce	22	**23**	4.55%
Heavy Piece Deduction	-4.6	**-4.6**	0.0%
Cards:			
Basic Automation	16.6	**17.4**	4.82%
3-Digit Cards	15.9	**16.7**	5.03%
5-Digit Cards	14.6	**15.4**	5.48%
Carrier Route Cards	14.1	**14.9**	5.67%

* Currently a combined 3/5-Digit rate.

Attachment USPS-33B

FIRST-CLASS MAIL TEST YEAR SUMMARY

	BEFORE RATES	AFTER RATES	% CHANGE
LETTERS SUBCLASS:			
Volumes	100,261,726	99,857,394	-0.40%
Revenues:			
Postage Revenue	$34,986,392	$36,041,609	3.02%
Fee Revenue	$156,588	$189,592	21.08%
Total Revenue	$35,142,980	$36,231,201	3.10%
Revenue Per Piece	$0.350512	$0.362829	3.51%
Costs:			
Total Costs (incl. contg.)	$18,565,943	$18,456,821	-0.59%
Cost Coverage	189.29%	196.30%	
Contribution	$16,577,037	$17,774,380	7.22%
CARDS SUBCLASS:			
Volumes	5,584,931	5,440,951	-2.58%
Revenues:			
Postage Revenue	$1,021,746	$1,043,775	2.16%
Fee Revenue	$7,500	$8,914	18.85%
Total Revenue	$1,029,246	$1,052,689	2.28%
Revenue Per Piece	$0.184290	$0.193475	4.98%
Costs:			
Total Costs (incl. contg.)	$727,672	$708,877	-2.58%
Cost Coverage	141.44%	148.50%	
Contribution	$301,574	$343,812	14.01%
TOTAL FIRST-CLASS MAIL:			
Volumes	105,846,657	105,298,345	-0.52%
Revenues:			
Postage Revenue	$36,008,138	$37,085,384	2.99%
Fee Revenue	$164,088	$198,506	20.98%
Total Revenue	$36,172,226	$37,283,890	3.07%
Revenue Per Piece	$0.341742	$0.354079	3.61%
Costs:			
Total Costs (incl. contg.)	$19,293,615	$19,165,698	-0.66%
Cost Coverage	187.48%	194.53%	
Contribution	$16,878,611	$18,118,192	7.34%

Source: USPS-T-33 Fronk Workpaper at page 1.